Finansinspektionen’s Regulatory Code

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Finansinspektionen's general guidelines regarding credit risk management in credit institutions and investment firms;

decided on 7 June 2004.

Finansinspektionen provides the following general guidelines.

Scope and definitions

Section 1 Through these general guidelines, Finansinspektionen wishes to promote sound credit risk management in the institutions. The general guidelines describe what an institution should take into account when identifying, measuring, steering and exercising control over its credit risks.

Institutions vary in size and character. Therefore, the design of these guidelines is general in nature and allows for alternative solutions depending on the business and industry.

Section 2 The regulatory framework that applies to the institutions includes:
- a general provision regarding risk management in Chapter 6, section 2 of the Banking and Financing Business Act (2004:297),
- provisions regarding handling of loans and other exposures in Chapter 8 of the Banking and Financing Business Act (2004:297),
- provisions regarding lending in Chapter 3 of the Securities Business Act (1991:981), and
- provisions regarding decisions in lending matters in Chapter 6 of Members' Banks Act (1995:1570) and Chapter 3 of the Savings Banks Act (1987:619).

Section 3 Management of credit risks is a central part of an institution's business activities. In addition to these general guidelines, Finansinspektionen's general guidelines (FFFS 1999:12) regarding governance, internal information and internal controls within credit and securities institutions as well as investment fund companies are applicable in this area.

Section 4 These general guidelines should be applied by credit institutions, securities institutions and branches of foreign credit institutions and companies that have Finansinspektionen's permission to conduct banking, financing or securities business in Sweden.

Section 5 In these general guidelines the following meanings shall apply:

the duality principle: the principle that prevents any person alone from administering a transaction along the entire transaction chain, *institution*: lending companies subject to these general guidelines,

credit: a claim to fulfil a payment obligation that the institution holds or can hold with respect to a third party due to a legal relationship arising in the course of the institution's business,

credit decisions: decisions to grant or reject a credit application or change conditions in previously granted credit,

credit risk: the risk for losses due to the failure of a credit to be fulfilled,

credit risk management: identifying, measuring, steering and exercising control over credit risks,

limit: established limit for risk exposure in respect of e.g. a specific customer, customer group, market or product,

rating: the institution's rating of borrowers or credits taking into account the probability of default and the scope of the loss given default,

aggregate limit: aggregation of limits for groups of borrowers with common financial interests or other interdependent relationships, and

governance documents: the institution's credit strategy, policies, instructions and similar documents emanating from the board of directors with the aim of steering the institution's credit risk management.

Fundamental principles

Section 6 All lending is associated with risk. Therefore, the institution should exercise sound management of its credit risks and ensure that these risks do not exceed the levels set by the institution.

Section 7 The board of directors of the institution holds ultimate responsibility for the management of credit risk.

Section 8 A person should not participate in the management of a matter or in a credit decision that refers to a close relation, a close relation's firm or in other situations where there is a risk for conflicts of interest.

Section 9 The institution should have a clear strategy for the scope and focus of the consolidated credit risk to which the institution decides to expose itself. The credit strategy should express the characteristics the credit portfolio shall have with regard to composition, diversification and concentration. The credit strategy should also provide guidance regarding how risk should be taken into account when setting prices.

The institution should be prepared to change its credit strategy in response to changes in the financial environment if such a need arises. Therefore, the institution should develop the skills of its personnel and evaluate procedures, products and methods of working.

The credit strategy and other governance documents should be designed in such a manner that they can be applied without causing conflicts of interest due to other strategies and objectives in the institution.

Section 10 If multiple institutions are part of a group, the credit risk management should be carried out as uniformly as possible within the institutions. In such cases, the governance documents should be uniformly designed and applied. The group's aggregate exposure to a specific counterparty should be taken into account when the institutions make credit decisions.

Identifying credit risk

Section 11 The institution should be knowledgeable about the credit risk inherent to its business. Therefore, the institution should regularly identify the credit risk to which it is and may be exposed. The institution should take into account credit risk that can occur differently in different products and markets.

Measuring credit risk

Section 12 The institution should regularly measure and follow up the consolidated credit risk to which it is exposed.

In order to measure its credit risks, the institution should rate its borrowers or credits with regard to credit risk. The rating should be based on defined criteria that are evaluated on an ongoing basis. The quality of the information on which the rating is based should be such that the rating reflects actual conditions.

In accordance with established procedures and as the need arises, the institution should regularly re-evaluate the determined rating for a specific borrower or credit.

Section 13 The measurement process as a minimum should make it possible to:

a) analyse the credit portfolio's composition with regard to risk,
b) regularly monitor the development of the credit risk of an individual credit or the entire credit portfolio, and
c) analyse sensitivity to changes.

Reporting within the institution

Section 14 The institution should have information systems for reporting credit risk. With regard to the institution's reports, the institution should have established guidelines for content, recipients, reporting managers and on which occasions the reporting should be provided.

Governance documents

Section 15 The institution should have adopted governance documents in writing for its credit risk management. The governance documents should be adapted to the institution's organisation and method of working and as a minimum include information about:

a) the units within the institution that may make credit decisions and the conditions for being allowed to make decisions in these units,
b) the units' authorisations to make credit decisions, e.g. with regard to monetary limits,
c) the extent to which different assets can be accepted as collateral and how they shall be valued,
d) principles for how a limit is determined, when aggregate limits shall apply and when a limit shall be re-evaluated,

e) the conditions under which a credit may be granted via a single person's decision,
f) the grounds upon which a member in a decision-making unit is appointed and how this happens,
g) how credit risk shall be identified and measured (see sections 11, 12 and 13),
h) the extent of the institution's credit risk reporting (see section 14),
i) requirements on the extent of the underlying basis for the analysis of a credit assessment (see section 16)
j) how past due credits and credits with increased risk shall be managed (see section 18),
k) the scope of the work of the risk control function (see section 19).

The governance documents should be adopted on an annual basis. They should be well-communicated throughout the organisation and regularly evaluated.

Credit assessment

Section 16 The purpose of the credit assessment is to evaluate whether or not a credit can be granted in respect of the institution's requirements.

The credit assessment should be based on information that provides an accurate picture of the credit applicant's financial status. It should include a sensitivity analysis of the credit applicant's repayment capacity and an assessment of the risk for a deterioration in the value of collateral.

The criteria for credit assessment should be established on an annual basis and regularly evaluated.

Credit decisions

Section 17 Credit decisions granting a credit or modifying the conditions of a previously granted credit should only be made following a credit assessment that complies with the procedures established by the institution.

The credit decision should be documented in such a manner that it presents the unit in which the decision was made and the members that participated in the decision. The documentation should also include the deliberations serving as the basis for the decision and the credit conditions, such as the amount, maturity, interest rate, amortisation and collateral.

Participants in the credit decision should ensure that the basis for the decision is of acceptable quality and that the credit is in line with governance documents. Participants should also be able to withstand pressure about the desired content of the decision.

Past due credits and credit with increased risk

Section 18 The institution should be able to identify growing credit risk at an early stage and be well prepared for managing such a trend.

The governance documents should set out the allocation of authorisations between the units that may make decisions about procedures with regard to borrowers when securing repayment.

Past due credits and credit with increased risk should be handled rapidly to avoid a worsened outcome in efforts to secure repayment or in any other way reduce the credit risk.

Experience from handling past due credits and credits with increased risk should be drawn upon when evaluating the credit strategy and the rating criteria.

Risk control

Section 19 The institution should have a central function for independent control and analysis of credit risk. The function should report to the board of directors, senior management and other parties with a need for the information. Reporting should provide a comprehensive and objective picture of the institution's credit risks and contain analyses of trends in the institution's credit risks. The function should also propose changes to governance documents and processes resulting from its observations of credit risk management.

The function should report to the managing director or another member of senior management who reports directly to the managing director and is not responsible for the daily credit management or business activities, but is knowledgeable about credit risks.

The function's duties should not be performed by personnel engaged in the ongoing credit management or other business activities. The function should have sufficient resources for its duties and its personnel should be knowledgeable about credit risks.

The work of the function may be structured in a number of ways depending on the institution's operations. The function can, for example, engage other functions in the institution to compile data for its reports and analyses. However, the function is at all times responsible for the full reporting and analysis of the institution's credit risks, and for ensuring that the underlying data is correct.

Credit culture

Section 20 The institution should have a sound credit culture. The professional values and norms related to credit issues within the institution's credit organisation, from the board of directors to line staff, together form the credit culture and play an important role in the quality of the credit risk management.

A sound credit culture is built on a number of different factors. For example:

- a business-like and risk-minded approach to credit issues,
- good knowledge about the customer,
- a credit administration in which all steps of the process, from the assessment of a credit application to the repayment or settlement of a credit, function without undue delay,
- appropriate manuals for practical work related to credit administration, e.g. evaluation of collateral, guarantors and business lending,
- rational processes with functions that prevent the risk for mistakes and breaches of authority,
- that changes in the institution's business are preceded by thorough development and test procedures to ensure control of credit risks,
- avoidance of situations in which there is a risk for conflicts of interest,
- application of the duality principle,
- a restrictive approach to single-person decisions, and

– ensuring that remuneration systems do not obstruct sound credit risk management.

These general guidelines shall enter into force on 1 July 2004, whereupon Finansinspektionen's General Guidelines (FFFS 1995:49) regarding credit risks in credit institution and investment firms shall be repealed.

INGRID BONDE

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